WORLD BANK GROUP

UKRAINE: UKRZALIZNYTSIA (UZ) MODERNIZATION STRATEGY

Policy Note 4: Debt management

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Acknowledgments

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Contents

Preface

This Policy Note is one of a series of individual papers originating in a request from Ukraine's Ministry of Infrastructure (MoI) and JSC Ukrzaliznytsia (UZ) to the World Bank to address specific topics concerning Ukraine's railway sector. The Policy Notes address the following topics.

1. **Railway market opening for cargo services:** progress in the meeting rail commitments in the EU-Ukraine Association Agreement, reorganization of UZ, Ukraine's readiness for and implications of market opening, pre-requisites to avoid leaving UZ in an unfavorable situation.
2. **Loss-making long-distance passenger services:** service costing, institutional and financial options for providing sustainable transport passenger services for long distance travel.
3. **Selected Freight Business Issues**: specific matters on which Bank advice has been sought including cargo tariffs, customer service and perceptions, and operating efficiency.
4. **Debt management**: options for UZ to restructure its debt and reach a financially stable situation.
5. **Infrastructure asset management and prioritization of investment.** Asset management strategy and life-cycle costing in the renewal and reconstruction of UZ's railway infrastructure network.

This Policy Note is for **Topic 4: Financial sustainability and debt management**.

Glossary of terms and acronyms

CURRENCY EQUIVALENTS

Exchange Rate (Feb 2019)

Currency Unit: Ukrainian Hryvnia (UAH)

USD 1 = UAH 26.9

ACRONYMS

AMS	Asset Management System
AMCU	Antimonopoly Committee of Ukraine
CoM	Cabinet of Ministers
EBIT	Earnings before interest and tax
EBITDA	Earnings before interest, tax, depreciation and amortization
EU	European Union
GoU	Government of Ukraine
IFRS	International financial reporting standards
MoF	Ministry of Finance
MoI	Ministry of Infrastructure
NBU	National Bank of Ukraine
PPE	Property, plant and equipment
PSO	Public Service Obligation
SART	State Administration of Railway Transport
USD	United States Dollar
UZ	Joint Stock Company, JSC Ukrzaliznytsia (registered October 2015)

Summary of Findings and Recommendations

This note focuses on the current debt situation of UZ, the associated risks and ways to manage them. It does not address broader financial sustainability issues and how to finance the investment backlog. This is of paramount importance and should be a priority for future work.

This note uses an analysis of the available audited financial statements in the January 1, 2014 –June 30, 2018 period to discuss risks and concerns regarding the financial viability of the UZ going forward given the near-critical liquidity situation and widespread solvency concerns in the financial markets.

As confirmed by the developments in the second half of 2018 and the first quarter of 2019, most of the liquidity and credit worthiness risks detected in the analyzed period increasingly materialized in the recent 9-12 months. As a result, UZ is facing significant difficulties in refinancing its maturing short-term loans and corporate bonds both in domestic and international markets. The absence of (institutional and guarantee) support from the Ministry of Finance made things more difficult.

Over the last few years, this led to further involuntary reduction in both short term and long-term loans and in debt/equity ratio. Under normal circumstances, such a low level of indebtedness (less than 20%) would attract investors' and financiers' attention and lead to business expansion. This is not the case with UZ due to the unclear position of the state (the owner) vis-à-vis the status of the company. It could also be insufficient confidence of the recent asset revaluation exercise based on pure accounting rules.

This Note suggests some steps for ameliorating the present dire liquidity situation: (i) A clear market opening and corporate restructuring strategy; (ii) detailed review of the asset valuation exercise carried out by reputable asset evaluators; (iii) based on the results of asset revaluation, seek Government consent to sell non-core assets and (iv) seek support in raising substantial investment resources at reasonable cost necessary to carry out the adopted modernization strategy and reach sustainable levels of business operation in the medium-to-longer run (such as increasing the share of current assets by selling non-core fixed assets such as land and buildings).

Any sustainable solution going forward, hinges on an open commitment to market opening and deep organizational and management restructuring programs discussed in other policy notes. Given the ownership structure, political and social importance of UZ, and the legal status of the company, this cannot be done without full ownership and support of the government (including the Ministry of Finance).

Additionally, given the size of the company and present institutional and governance risks, successful restructuring and changed perception of domestic and international financial markets will critically depend on the credibility of the proposed program.

1. Financial Performance of UKRZALIZNYTSIA

1.1 The creation of public JSC UKRZALIZNYTSIA

The public railway company JSC Ukrzaliznytsia (UZ) was created as a public Joint Stock Company through reorganization of public service railway organizations and institutions subordinated to and controlled by the business group State Administration of Railway Transport (SART) "Ukrzaliznytsia" (the SART Group). JSC UZ was registered on October 21, 2015 and effectively started operation on December 1, 2015. All assets and liabilities of entities previously controlled by the SART Group were transferred to new joint stock company.[1]

Despite significant legal and organizational change, UZ management believed that the reorganization did not result in any significant change in the substance of economic activities, nor qualitative and quantitative characteristics of assets and liabilities.[2] Hence, the financial performance of the new company has been evaluated through consolidated financial statements (generated on the basis of "pooling of interest method"), independently audited and publically disclosed.

1.2 Financial statements of JSC UKRZALIZNYTSIA

Based on audited annual consolidated financial statements for years 2015-2017, and unaudited interim consolidated financial statements for the first six months of 2018, the Bank team compiled summary tables with: financial position of the company (balance sheet – Table 1); and comprehensive income (profit and loss statement – Table 2).

Table 1 indicates a huge discontinuity in the financial position of the UZ due to external shocks. The first shock came from a sizeable 50 percent depreciation of the exchange rate, from UAH 15.6 per one USD at the end of 2014, to UAH 23.4 per one USD at the end of 2015. This created massive foreign exchange losses (USD 1,197 million – Table 2) which explain 89.7 percent of the accumulated deficit (USD 1,335 million) carried forward to 2015.

The second shock was even bigger and came from the revaluation of UZ fixed assets (Property, Plant and Equipment – PPE) in the amount of USD 8,507 million. The application of Ukrainian accounting rules, which did not comply with international standards (IFRS), increased the value of non-current (fixed) assets by 97.8 percent in USD terms (and 196.6 percent in UAH terms). The revaluation increase was distributed unevenly across key elements of PPE. The value of land (which was previously not valued at all) was increased by USD 1,951 million; buildings by USD 2,123; infrastructure by USD 2,899; locomotives by USD 245 million; and railway cars by USD 896 million. To balance the books, net equity in dollar terms was increased from USD 1,780 million to USD 9,326 million, i.e. by 424 percent or more than 5.2 times.

As a result of biases introduced by these adjustments, standard solvency and debt ratios that reference asset and equity values exhibit a large degree of instability between 2014 and 2015, and

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[1] In addition, some health care institutions were merged into JSC UZ. Corporate rights of seven railway JSC owned by the State were also included in the charter capital of the new JSC UZ.

[2] Based on Ernst & Young JSC UZ Audit report for 2015.

then stabilize at different significantly lower levels (from 3 times lower for Debt/Asset ratio to 6 times lower for Debt/Equity ratio).

Table 1: JSC UZ – Financial Position (Balance sheet), 2014-2018*

					In mill US $
	2014	2015	2016	2017	2018*
ASSETS					
Non-Current Assets	4,302	11,141	9,548	9,057	9,496
*Of which: Revaluation of PPE***	-	*8,507*	-	-	-
Current assets	421	557	599	559	453
Of which: Cash	*131*	*209*	*244*	*189*	*59*
TOTAL ASSETS	**4,723**	**11,698**	**10,146**	**9,616**	**9,950**
EQUITY					
Capital	1,195	10,661	9,486	9,047	9,496
Acc. deficit/ret. earnnings	585	(1,335)	(1,470)	(1,382)	(1,434)
NET EQUITY	**1,780**	**9,326**	**8,016**	**7,665**	**8,061**
LIABILITIES					
Non-Current Liabilities	606	1,028	1,021	1,090	905
Of which: MLT Loans	*367*	*905*	*906*	*823*	*627*
Current Liabilities	2,336	1,343	1,110	862	984
Of which: ShT Loans	*1,626*	*889*	*634*	*396*	*550*
TOTAL LIABILITIES	**2,943**	**2,371**	**2,131**	**1,952**	**1,888**
TOTAL EQUITY and LIABILITIES	**4,723**	**11,698**	**10,146**	**9,616**	**9,950**

*) First six months.
**) PPE = Property, plant and equipment
Source: UZ publicly disclosed data converted at NBU official end of period exchange rate.

Regarding revenue dynamics presented in Table 2, there was a sizeable 33 percent decline of equivalent dollar earnings in 2015 following a large UAH depreciation. The structure of revenues remained fairly stable with cargo contributing slightly over 80 percent, and passenger transport about 10 percent. Operating expenses declined even more with weaker local currency mainly due to lower wages and other operating costs. Combined energy costs (electricity and fuel) retained a stable 22-23 percent share of operating expenses. There was an expected large increase in depreciation charges in 2016 following the revaluation of assets in 2015 already discussed. Because of that, EBITDA is much more stable over the years than the operating profit (EBIT).

It should be stressed that both EBIT and EBITDA have been positive during the entire 2014-2018 period. Overall company losses are caused entirely by large interest payments and other financial costs, as well as foreign exchange losses which exceeded USD 1.8 billion in 2014-2015 and USD 2 billion during the 2014-2017 period.

Table 2: JSC UZ – Comprehensive Income Statement, 2014-2018*

						In mill US $
	2014	2015	2016	2017	2017*	2018*
					Jan-June	
Total revenues	**4,156**	**2,745**	**2,600**	**2,780**	**1,316**	**1,497**
Cargo	3,303	2,242	2,127	2,260	1,082	1,226
Passenger	442	274	263	275	127	140
Other	411	230	211	245	108	132
Operating expenses	**3,886**	**2,481**	**2,528**	**2,579**	**1,274**	**1,493**
Staff costs	1,912	1,023	1,003	1,202	558	748
Electricity	436	297	305	296	148	168
Fuel	415	268	230	275	131	165
Other operating costs	649	572	291	255	150	151
Depreciation	473	321	700	551	287	260
Operating profit	**270**	**264**	**72**	**201**	**42**	**4**
EBITDA	**743**	**586**	**772**	**752**	**329**	**264**
Finance income	4	14	14	21	10	5
Finance cost	(311)	(234)	(188)	(143)	(75)	(69)
Of which: Interest paid	(253)	(183)	(158)	(129)	(65)	(55)
ForEx losses	(1,197)	(635)	(177)	(49)	46	87
Profit/Loss before income tax	**(1,234)**	**(591)**	**(278)**	**29**	**23**	**28**
Income tax	**(64)**	**(175)**	**(8)**	**(25)**	**(18)**	**(10)**
PROFIT/LOSS after tax	**(1,298)**	**(766)**	**(286)**	**4**	**5**	**18**
Revaluation surplus / loss	**3**	**9,090**	**(4)**	**(7)**	**-**	**-**
Total Comprehensive Income	**(1,295)**	**8,323**	**(290)**	**(3)**	**5**	**18**
Memo: Financing gap						
Net Cash flow from financing **	(73.51)	(210.81)	(259.83)	(181.21)	(92.33)	(31.52)
*) First six months.						
**) Proceeds from minus repayments of loans, bonds and borrowings.						
Source: UZ publicly disclosed data converted at NBU official period average exchange rate.						

1.3 Liquidity, Solvency and Debt Indicators

As detailed in Table 3 below, UZ has chronic liquidity problems. Current ratio has been consistently improving over the past four years but, at 0.65 in 2017 and 0.46 during the first half of 2018, it still lags markedly behind the industry standard (0.8), and even more behind the desired norm (1.0). Cash ratio has been improving during the 2015-2017 period but has deteriorated in 2018.

Solvency indicators, both Debt/Equity and Debt/Asset ratios, are nominally very good (around 0.25 and 0.20 respectively). For the most part this reflects the bias introduced by a massive USD 8.5 billion accounting revaluation of PPE in 2015 which does not necessarily reflect realistic market value of fixed assets.

Regarding the term structure of loans, during 2015-2017 period UZ was successful in embarking on a desirable trend of increasing the share of long-term loans and decreasing the share and the dollar equivalent amount of short-term loans. This trend has been reversed in 2018 as the equivalent dollar value of short-term loans increased and almost equaled the value of longer-term loans.

Short maturities, unfavorable credit rating and high spreads (over 900 basis points), resulting in very high interest rates, as well as increasingly limited access to international financial markets have all created tensions in raising new financing to meet the debt service payments and refinancing maturing bonds.

Table 3: JSC UZ – Select Liquidity, Solvency and Debt Indicators, 2014-2018*

	Reference	2014	2015	2016	2017	2018*
LIQUIDITY RATIOS						
Current Ratio[1]	*0.80*	0.18	0.41	0.54	0.65	0.46
Cash Ratio[2]	*0.22*	0.06	0.16	0.22	0.22	0.06
SOLVENCY and DEBT RATIOS						
Debt to Equity Ratio[3]	*0.58*	1.65	0.25	0.27	0.25	0.23
Debt to Asset Ratio[4]	*0.24*	0.62	0.20	0.21	0.20	0.19
Interest Coverage Ratio EBIT[5]		1.07	1.45	0.45	1.55	0.07
Interest Coverage Ratio EBITDA[6]		2.94	3.21	4.87	5.82	4.81
Memo:						
Total Loans to Equity		1.12	0.19	0.19	0.16	0.15
MLT Loans to Equity	*0.58*	0.21	0.10	0.11	0.11	0.08
ShT Loans to Equity		0.91	0.10	0.08	0.05	0.07
Total Loans to Assets		0.42	0.15	0.15	0.13	0.12
MLT Loans to Assets	*0.24*	0.08	0.08	0.09	0.09	0.06
ShT Loans to Assets		0.34	0.08	0.06	0.04	0.06
Averge interest rate (AIR) [7, 8]		12.7%	10.2%	10.3%	10.6%	9.3%

*) First six months.

Source: Staff calculations based UZ publicly disclosed data converted at NBU official ER.

1) Current Assets / Current Liabilities

2) Cash and marketable securities / Current Liabilities

3) Total Liabilities / Equity

4) Total Liabilities / Total Assests

5) Operating Income EBIT / Interest payments

6) Operating Income EBITDA / Interest payments

7) Interest payments / Total Loans

8) AIR for 2018 is calculated assuming equal interest payments in H1 and H2.

2 Assessing of UZ Financial Position

2.1 Liquidity as a formal binding constraint

UZ obviously has liquidity problems, both in terms of securing sufficient current assets to meet current (short-term) liabilities and generating enough free cash to meet its imminent payment obligations and investment needs. Under normal circumstances a solvent corporation with low indebtedness, good management and solid business model should not have any problems raising additional financing against its net equity in excess of USD 9 billion.

However, in the presence of substantial country risk, unclear quality of corporate governance, and lack of reform commitment to legal and organizational reform of the railway, tight liquidity situation becomes an effective binding constraint. Paradoxically, good solvency indicators and present low level of indebtedness (long-term loans to equity of only 8 percent) do not support the "benefit of doubt" argument but rather exacerbate concerns about overemployment, weak governance, inefficient use of resources, unreasonable public and political expectations regarding PSO and subsidized cargo tariffs.

2.2 Need for a new comprehensive debt and asset management strategy

Presently, UZ is faced with a lending premium of close to 1100 basis points (about 950 on the count of country risk and additional 150 for the corporate risk). The key objective of a successful debt management strategy is to focus on lowering those risk premia in the medium run by strengthening the quality and trust of UZ corporate governance, commitment to market opening ad comprehensive corporate restructuring.

Concurrently, UZ must make an effort to better manage its ample assets with current book value of close to USD 10 billion. According to some estimates, almost half of all assets contribute only ten percent of UZ revenue. There are strong indications that some rail segments can be shut down and replaced with bus service in line with PSO obligations. This would enable significant cost savings.

3 Next steps – Action plan

To overcome existing constraints in raising liquidity and investment financing in domestic and international markets, UZ should, first, commit to a clear market opening and corporate restructuring strategy.

Second, UZ must make a decisive move to conduct a detailed asset valuation exercise carried out by reputable asset evaluators. This exercise must be launched as soon as possible to arrive at reliable financial statements.

Third, based on the results of asset valuation, UZ should seek Government consent to sell (privatize) or leverage select assets not related to core business (such as buildings, urban land, etc.) to raise cash or marketable securities that would improve its liquidity position and enable normal operation.

Fourth, UZ should seek support in raising substantial investment resources at reasonable (low) cost necessary to carry out the adopted modernization strategy and reach sustainable levels of business operation in the medium-to-longer run. Potential partners are the Government of Ukraine, domestic and foreign business partners and investors (through bonds issued in domestic and international financial markets.